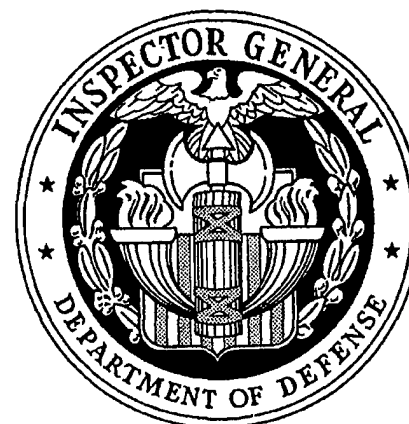


Audit Report



REACQUISITION OF SURPLUS MATERIEL BY THE DEFENSE LOGISTICS AGENCY

Report No. D-2000-171

August 9, 2000

Office of the Inspector General
Department of Defense

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Acronyms

DLA	Defense Logistics Agency
DRMS	Defense Reutilization and Marketing Service
DSCC	Defense Supply Center Columbus
DSCP	Defense Supply Center Philadelphia
DSCR	Defense Supply Center Richmond
FAR	Federal Acquisition Regulation
NAACS	National Association of Aircraft and Communications Suppliers



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

August 9, 2000

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on the Reacquisition of Surplus Materiel by the Defense Logistics Agency (Report No. D-2000-171)

We are providing this audit report for information and use. We performed the audit in response to a congressional request. We considered management comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Tilghman A. Schraden at (703) 604-9186 (DSN 664-9186) (tschraden@dodig.osd.mil) or Mr. Alexander L. McKay at (215) 737-5421, extension 232 (DSN 444-5421, extension 232) (amckay@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2000-171

(Project No. D2000LD-0024)

(Formerly Project No. OLD-5104)

August 9, 2000

Reacquisition of Surplus Materiel by the Defense Logistics Agency

Executive Summary

Introduction. This audit was conducted in response to a congressional request. Senator Robert C. Smith and Representative John E. Sununu expressed concerns to the Inspector General, DoD, that DoD demonstrated institutional prejudices against the surplus industry in its policies for awarding contracts. A constituent contractor lost a contract bid although he offered surplus materiel at a lower price than that offered by the original equipment manufacturer. After an appeal, the Comptroller General of the United States upheld the contract award decision and we did not revisit that decision. We did, however, review the process used by the Defense Logistics Agency to manage surplus property. The Defense Logistics Agency did not maintain specific records on the reacquisition of surplus materiel.

Objectives. Our overall audit objective was to evaluate the processes that DoD uses in the identification, redistribution, sale, and reacquisition of surplus materiel. Specifically, we evaluated the reacquisition of surplus materiel by the Defense Logistics Agency. We also reviewed the management control program as it related to the audit objective.

Results. The Defense Logistics Agency's reacquisition of surplus materiel, valued at about \$114,000, was reasonably justified. The Defense Logistics Agency generally followed DoD policy on the disposal of excess materiel and reacquired small quantities of surplus materiel with a low dollar value. The Defense Logistics Agency issued interim guidance in June 1999 to establish policy to standardize and improve the process for evaluating offers of surplus materiel, but the guidance has not been finalized. DoD could potentially reduce delivery times and put funds to better use by implementing standard procedures for acquiring surplus materiel.

Management controls that we reviewed were adequate in that no material management control weaknesses were identified. See the Finding section for details of the audit results and Appendix A for details of our review of the management control program.

Summary of Recommendation. We recommend that the Director, Defense Logistics Agency, expedite formal policy for processing and evaluating offers of Government surplus materiel.

Management Comments. The Defense Logistics Agency concurred with the report and recommendation and stated that the estimated completion date for final policy guidance is September 30, 2000. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

Congressional Request. The audit was conducted in response to a congressional request. On behalf of a constituent contractor, Senator Robert Smith and Representative John E. Sununu expressed concerns to the Inspector General, DoD, that DoD demonstrated institutional prejudices against the surplus industry in its policies for awarding contracts. The constituent contractor had bid unsuccessfully on a contract to supply a critical weapon system part from his surplus materiel inventory. The contractor lost the contract bid although he had offered surplus materiel at a lower price than that offered by the original equipment manufacturer. After an appeal, the Comptroller General of the United States upheld the contract award decision and we did not revisit that decision. We did, however, review the process used by the Defense Logistics Agency (DLA) to manage surplus materiel.

Surplus Materiel. Surplus materiel is materiel that was purchased and accepted by the Government and, subsequently, the requirement for the materiel diminished and it was sold at disposal. Certain contractors acquire that materiel at surplus sales and hold the inventory in anticipation of a future resale to private industry or the Government. Contractors who acquire and resell DoD surplus inventory are known as surplus dealers.

Disposal Policy. The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics established policy in DoD Regulation 4140.1-R, "DoD Materiel Management Regulation," May 1998, concerning the retention of inventory by DoD inventory control points. The policy states that DoD Components shall not stock an item that does not have any possibility of future demand. The policy identifies the requirements determination for materiel and the authorized stockage levels of inventory.

National Association of Aircraft and Communications Suppliers. Surplus dealers who buy and sell surplus Government inventory formed an organization in 1972 called the National Association of Aircraft and Communications Suppliers (NAACS). Surplus dealers in NAACS generally acquire surplus DoD inventory at a significantly reduced price from the Defense Reutilization and Marketing Service (DRMS), which operates under the direction of DLA.

Objectives

Our overall audit objective was to evaluate the processes that DoD uses in the identification, redistribution, sale, and reacquisition of surplus materiel. Specifically, we evaluated the reacquisition of surplus materiel by DLA. We also reviewed the management control program as it applied to the audit objective. Appendix A discusses the scope and methodology used to accomplish the objective, our review of the management control program, and prior coverage.

Reacquisition of Surplus Materiel

The DLA reacquisition of surplus materiel, valued at about \$114,000, was reasonably justified. DLA generally followed DoD policy on the disposal of excess materiel and reacquired small quantities of surplus materiel with a low dollar value for unique or changing requirements on an average of 7.2 years after the materiel was disposed of. In June 1999, DLA issued interim guidance to establish policy to standardize and improve the process for evaluating offers of surplus materiel, but the guidance has not been finalized. DoD could potentially reduce delivery times and put funds to better use by implementing standard procedures for acquiring surplus materiel.

Justification for the Reacquisition of Surplus Materiel

DLA reacquisition of surplus materiel, valued at about \$114,000, was reasonably justified. DLA had no database on reacquisitions or formal policy, guidance, or criteria on its processes for disposing and reacquiring surplus materiel. Therefore, to evaluate the DLA process, we devised a method for identifying contracts with surplus materiel and criteria for testing those contracts.

Contracts With Surplus Materiel. We identified 120 surplus dealers from NAACS data. DLA had no statistical data with which to rank surplus dealers by volume or dollar value of business with DoD. As an alternative, personnel at Defense Supply Center Richmond (DSCR) identified eight major dealers who sold surplus materiel to DLA. The three DLA supply centers, Defense Supply Center Columbus (DSCC), Defense Supply Center Philadelphia (DSCP), and DSCR, awarded 1,437 contracts to the eight dealers, valued at about \$20 million, from May 1998 through April 1999. We judgmentally selected 100 of the 1,437 contracts to identify procurement actions for surplus materiel. Of the 100 contracts in our sample, records were available for 73, valued at \$395,572. Of the 73 contracts, 43 were for surplus materiel, valued at \$113,947. The remaining 30 contracts were for new materiel.

Value and Significance of Reacquired Surplus Materiel. Because DLA did not maintain specific records on the reacquisition of surplus materiel, the total value of surplus materiel reacquired by DLA was unknown. We determined that the organized surplus dealers sold \$22 million of new and surplus materiel to DLA from May 1998 through April 1999. The value of the 43 contracts for surplus materiel reacquired by DLA from May 1998 through April 1999 was about 29 percent of the total value of the 73 contracts in our sample. NAACS could not provide a relative percentage, but considered our results a reasonable value for the industry.

Based on the 43 contracts in our sample, DLA reacquired small quantities of surplus materiel with a low dollar value for unique or changing requirements on an average of 7.2 years after the surplus materiel was disposed of. For the

43 contracts, the average contract action was for 62 items with a dollar value of \$2,650. Compared with the \$3.5 billion of spare parts that DLA purchased in FY 1999, surplus materiel represented only a small percentage of total acquisitions. Not only was the reacquisition of surplus materiel relatively small business for DLA, but resale of surplus inventory was not the primary source of business for the members of NAACS. NAACS estimated that members were able to resell only about 3 percent of the total surplus materiel acquired.

Compliance With DoD Disposal Policy. DLA generally followed DoD policy on the disposal of excess materiel. When demand for a wholesale inventory item decreases below the DoD-established criteria for retention, DoD Regulation 4140.1-R directs that the inventory in excess of requirements be identified as potential reutilization stock for transfer to DRMS. After that stock completes DRMS disposal processing, surplus dealers may acquire excess Government inventory for resale. DLA and the Military Departments disposed of the items in the 43 contracts at different times during the past 31 years and all the items were disposed of before the implementation of the current regulation. Consequently, we could not effectively evaluate DLA compliance with disposal policy for all the items in the 43 contracts. However, four of the contracts included items that had been disposed of within the last 5 years. We evaluated DLA disposal actions on the surplus materiel related to those contracts, and we determined that DLA actions in those cases were in compliance with DoD policy. In addition, we determined that policies and procedures for disposing excess materiel were in place at the DLA supply centers and that those policies were consistent with DoD policy.

Criteria for Reacquiring Surplus Materiel. The procurement and demand histories for the 43 contract actions showed that the reacquired surplus materiel fell into one or more of four categories supporting the DLA decision to reacquire surplus materiel and that the decision was consistent with DoD disposal policy. The four categories were the following.

- Contingency generated a demand surge for an item that had been disposed of within 5 years of the reacquisition.
- Interval from the time of the disposal action for an item until a contract for the same item was awarded by DLA was 5 or more years.
- Military Departments disposed of the item that DLA later reacquired to satisfy a unique requirement.
- Unique requirement for Foreign Military Sales was submitted to DLA for acquisition of the item.

Demand Surge. For 8 of the 43 contracts in our sample, demand surged for an item after it was disposed of. The procurement and demand histories for the items in four of the eight contracts indicated that DLA had generally complied with DoD disposal policy in that the items were excess and had been properly disposed of. However, because of various contingencies,

demand for the items surged significantly within 5 years of disposal. For example, in May 1998, DSCR issued contract SP0475-98-M-NA31 to acquire a latch-plate assembly, national stock number 1560-00-829-6060, for \$35 from Alamo Aircraft Supply, Inc. The item had been disposed of by DSCR in 1994. The item was disposed of by DSCR in 1994 because the item had no demand, which was in accordance with DoD policy. In 1997, the demand for the item increased to 29 units and continued at 28 units for FYs 1998 and 1999.

Time Intervals. For 18 of the 43 contracts in our sample, DLA did not award contracts for reacquiring the item until 5 to 31 years after the disposal action for the item. If DLA acquired surplus materiel that had been held by a surplus dealer for less than 5 years, the action could suggest that the materiel had not been properly evaluated as excess and may have been disposed of prematurely. The average time for reacquiring an item after it was disposed of was 7.2 years for the items in the 43 contracts, and 41.9 percent had been held by a surplus dealer in inventory for 5 or more years. The relatively long period between disposal and reacquisition indicated that DLA generally processed the disposal of the items in accordance with DoD Regulation 4140.1-R.

Items Disposed of by the Military Departments. For 17 of the 43 contracts in our sample, the disposal action of the surplus materiel was accomplished by the Military Department that initially managed the item. The management of the item was subsequently transferred to DLA as part of the Consumable Item Transfer program. Consequently, DLA did not have a history of the disposal action and would not be accountable if the disposal action had been inappropriate. DLA awarded contracts for 17 items that could not be readily filled from public or private stock, which constituted unique requirements for the items. For example, in August 1998, DSCC issued contract SP0920-98-M-5207 to acquire one duct assembly, national stock number 1660-00-791-4180, for \$300 from Lee Air Company, Inc. The item was surplus materiel that had been disposed of by the Air Force in 1970.

Foreign Military Sales. For 15 of the 43 contracts in our sample, DLA awarded the contracts to fill a Foreign Military Sales requirement. In those instances, the requirements were unique because the surplus materiel was for non-DoD customers who submitted irregular, nonrecurring requirements that were not computed with the normal demand cycle of DoD customers. DLA awarded contracts on behalf of foreign governments and the Foreign Military Sales requirements were funded by the foreign governments.

Interim Guidance

Before June 1999, DLA did not have formal procedures on evaluating offers of Government surplus materiel made by private industry. Contracting officers determined provisions on surplus materiel in accordance with DLA Directive 4105.1, "Defense Logistics Acquisition Directive," November 21, 1997, that implements the Federal Acquisition Regulation (FAR). The FAR offers only general policy concerning the issuance of contracts.

On June 1, 1999, DLA issued interim guidance to standardize and improve the process for evaluating offers of surplus materiel. The interim guidance was to be in effect for 6 months to identify necessary procedures until permanent policy could be implemented. Supplementary guidance was issued on June 18, 1999, to clarify the intent of the June 1, 1999, interim guidance. As of April 2000, the guidance had not been finalized. The interim guidance institutionalized procedures by specifically requiring contracting officers to evaluate offers of surplus materiel when the offer is in line for award and:

- there are no other sources;
- the purchase will avoid or significantly improve a backorder situation;
- minimum savings will cover the cost of evaluation; or
- urgency of need overrides the cost.

The interim guidance had provisions for surplus dealers to submit supporting documentation of an item and special provisions for critical items. The interim guidance required that offers of surplus materiel have supporting documentation that demonstrated that the materiel was previously owned by the Government. Examples of supporting documentation included original packaging, original contract numbers, shipment receipts, disposal turn-in document numbers, requisition numbers, delivery order numbers, and billing documents with requisition and national stock numbers. Because of the nature of critical items, the interim guidance stated that offers of surplus materiel were generally to be evaluated only to accommodate unique emergencies such as when the original equipment manufacturer was out of business, the weapon system was obsolete, or the sole vendor did not respond.

On June 18, 1999, DLA issued a supplement to the June 1, 1999, interim guidance because some employees misinterpreted the interim guidance. The employees interpreted the guidance to mean that if a non-surplus source existed, surplus offers did not have to be evaluated. The June 18, 1999, guidance clarified that the intent of the interim guidance was that offers of surplus materiel shall be evaluated when:

- the offerer is otherwise in line for award, after adding the cost of evaluation;
- avoidance or significant improvement of a backorder situation, or the urgency of need, overrides other factors; or
- there are no other sources.

The clarification of the interim guidance was intended to emphasize the importance of reducing backorders in an attempt to meet performance goals for logistics response times.

The June 1, 1999, interim guidance and the June 18, 1999, clarification were issued for a 6-month period. During the 6-month period, the DLA supply centers were to identify required changes for the guidance, based on actual experience at the supply centers. The guidance was then to be adjusted accordingly and published in final form. As of April 30, 2000, 11 months after the interim guidance was issued, DLA had not published the revised, final policy.

Conclusion

Surplus dealers speculating in surplus materiel provide a legitimate, cost-effective, and expeditious avenue for DoD customers, through DLA, to satisfy unprogrammed demands for materiel. DLA generally practiced reasonable control over the reacquisition of surplus materiel by issuing and following general guidance on disposals and by minimizing reacquisitions of surplus materiel. In certain instances, reacquiring surplus materiel may be beneficial to DoD. For example, if a DoD customer needed an item that was out of production, reacquiring surplus materiel from surplus dealers may cost less than if the out-of-inventory, out-of-production item were purchased from the original equipment manufacturer. Likewise, surplus materiel can be a readily available alternative for urgent DoD requirements. Because DLA had not implemented formal policy and standard procedures on the reacquisition of surplus materiel, DoD customers could miss opportunities to purchase surplus materiel at a cost savings and to reduce delivery times for items needed in an emergency.

Recommendation and Management Comments

We recommend that the Director, Defense Logistics Agency, expedite formal policy for processing and evaluating offers of Government surplus materiel.

Management Comments. DLA concurred, stating that the estimated completion date for final policy guidance is September 30, 2000.

Appendix A. Audit Process

Scope

We assessed the DoD and DLA policies and procedures related to the disposal and reacquisition of surplus materiel, dated from September 1995 through June 1999. We reviewed procurement histories and contract files for contracts that DLA awarded to reacquire surplus materiel, including documents that certified as to the condition of the materiel. The contracts were awarded from May 1998 through April 1999. We also interviewed item managers, contracting officers, DRMS personnel, and NAACS surplus dealers to determine DoD and industry practices for disposing and reacquiring surplus materiel.

DoD-Wide Corporate Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measure.

FY 2000 DoD Corporate Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. (00-DoD-2)

FY 2000 Subordinate Performance Goal 2.3: Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing business practice reforms. (00-DoD-2.3)

FY 2000 Performance Measure 2.3.4: Logistics response time. (00-DoD-2.3.4)

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following Logistics Functional Area objective and goal.

Objective: Streamline logistics infrastructure. **Goal:** Implement most successful business practices (resulting in reductions of minimally required inventory levels). (LOG-3.1)

High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Inventory Management high-risk area.

Methodology

We selected a judgmental sample of 100 contracts out of 1,437 contracts awarded by the three DLA hardware centers DSCC, DSCP, and DSCR to eight contractors who deal in surplus materiel. We reviewed available contract folders from our sample to determine which of the contracts were for surplus materiel. Using that method, we identified 43 contracts that were issued for the reacquisition of surplus materiel. The 43 contracts were valued at \$113,947.

Use of Computer-Processed Data. We used computer-processed procurement histories provided by USA Systems Inc., a contractor that maintains logistics procurement information for DoD, in the selection of our sample. To the extent that we reviewed the computer-processed data, we concluded the data were sufficiently reliable to be used in meeting our objectives. We did not audit the system that produced the data.

Audit Type, Dates, and Standards. We performed this economy and efficiency audit from December 1999 through April 2000 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD and DoD contractors. Further details are available upon request.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of the DLA management controls over the disposal and reacquisition of surplus inventory. We did not assess the adequacy of management's self-evaluation because no material weaknesses were identified.

Adequacy of Management Controls. The DLA management controls we reviewed needed improvement, in that standard policy for evaluating offers involving surplus material was lacking. Because we found no significant impact, we did not consider this to be a material management control weakness. However, it would be prudent to minimize risk by implementing the audit recommendation and issuing policy to eliminate the control weakness.

Prior Coverage

There was no prior coverage in the past 5 years on the reacquisition of surplus materiel by DLA.

Appendix B. Report Distribution

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Under Secretary of Defense for Acquisition, Technology, and Logistics
Deputy Under Secretary of Defense (Logistics)
Assistant Deputy Under Secretary of Defense (Supply Chain Integration)
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Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
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Deputy Comptroller (Program/Budget)

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Auditor General, Department of the Army

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Auditor General, Department of the Navy

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House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform

Honorable Robert C. Smith, U.S. Senate
Honorable John E. Sununu, U.S. House of Representatives

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Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8726 JOHN J. KINGMAN ROAD, SUITE 2533
FORT BELVOIR, VIRGINIA 22060-6221

IN REPLY
REFER TO J3

JUL 27 2000

MEMORANDUM FOR DDAI

SUBJECT: Draft Report on Reacquisition of Surplus Materiel by the Defense Logistics
Agency, OLD-5104

As requested in your memorandum dated May 30, 2000, attached are J3's comments on the
subject report.

D. H. STONE
Rear Admiral, SC, USN
Director
Logistics Operations

Attachment



IN REPLY
REFER TO J33

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221



JUL 20 2000

MEMORANDUM FOR J-33 (Charlene Mann)

SUBJECT: DoDIG Draft Report, "Reacquisition of Surplus Materiel by the Defense Logistics Agency, OLD-5104

DLA concurs with the subject report and the DoDIG recommendation, "...expedite formal policy for processing and evaluating offers of Government Surplus materiel."

Estimated completion date for final policy guidance is September 30, 2000.

WILLIAM S. FINKEL
Chief, Product Assurance Branch
Technical Services Division

Audit Team Members

The Readiness and Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

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